No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,
v.
FEDERAL DEPOSIT INSURANCE CORPORATION,
AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK,
ADC FINANCIAL CORPORATION, AMERICAN
DIVERSIFIED/WELLS PARK II, AND AMERICAN
DIVERSIFIED/GATEWAY CENTER,
Respondents,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

AMICUS CURIAE BRIEF OF BEUS, GILBERT & MORRILL, P.L.L.C. IN SUPPORT OF THE POSITION OF PETITIONER O'MELVENY & MYERS

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Pursuant to Rule 37 of the Rules of the Supreme Court of the United States, *amicus curiae* Beus, Gilbert & Morrill, P.L.L.C., ("BG&M") respectfully submits this brief in support of the Petition of O'Melveny & Myers ("O'Melveny") for Writ of Certiorari (the "Petition"). Petitioner and Respondents have both consented to BG&M's filing of this brief *amicus curiae.*

INTEREST OF *AMICUS CURIAE*

BG&M is a law firm engaged in the general practice of law in Phoenix, Arizona. From 1982 through 1989 BG&M performed certain discrete services for Western Savings & Loan Association ("Western"), an Arizona chartered, federally insured, association. Western was founded in 1929 by the Driggs family and provided housing finance in Arizona until it was taken over by FDIC on June 14, 1989. Western was the second largest Arizona savings and loan in 1989, with assets of over $5.0 billion. BG&M was not general counsel, securities counsel, or regulatory counsel for Western, and was never engaged to advise it on financial or accounting issues. BG&M had no lawyers who were on Western's board of directors or who otherwise participated in the management or business planning of Western. Instead, BG&M provided to Western, on request, legal services in the areas of foreclosures, zoning and land use planning, commercial litigation, and documentation of loan transactions.

On June 13, 1992 the Resolution Trust Corporation ("RTC") filed in the federal district court for the district of Arizona, its complaint styled *Resolution Trust Corporation v. Driggs, et. al.* Cause No. CIV 92-1080-PHX-EHC. In that action the RTC alleges that a "Control Group" of "racketeers" at Western caused it to engage in imprudent lending practices and improper accounting for sales of real estate. The RTC named BG&M as a defendant in that action, asserting that as transactional counsel engaged by Western to document loans previously underwritten and approved

by Western's in-house lending experts, BG&M had an obligation to perform its own financial underwriting of prospective borrowers, verify that appraisals Western obtained on collateral were sound, audit compliance by Western's loan officers, appraisers, and loan committees with prudent loan underwriting standards and regulatory recordkeeping requirements, and, in effect, determine at the time a transaction was being documented, that the "Control Group" would later improperly account for real estate sales. Had BG&M done so, RTC alleges, it would have prevented Western from entering into the transactions BG&M documented, which had been duly approved by Western's internal loan underwriting and approval process.

Because the duties alleged by RTC against BG&M do not exist under traditional state law principles of professional liability, RTC is apparently contending as did FDIC in this case, that some federal common law rules should be invented to create liability where none exists under state law and thereby "maximize the asset pool."

STATEMENT OF THE CASE

The FDIC filed this action as receiver for American Diversified Savings Bank ("ADSB"), a failed California savings and loan association, formerly represented by O'Melveny. It alleged legal malpractice and breach of fiduciary duty in connection with preparation of two offering memoranda for real estate securities offerings sponsored by ADSB affiliates. O'Melveny asserted that ADSB's 100% shareholders and principal officers and directors were well aware of the facts allegedly not disclosed in the offering memoranda, and actively concealed the information from O'Melveny. Therefore, O'Melveny contended, it did not owe a duty to discover and inform ADSB of that which it already knew and was concealing from O'Melveny. The district court granted summary judgment to O'Melveny. On appeal, the Court of Appeals for the Ninth Circuit reversed. *F.D.I.C. v. O'Melveny & Myers,* 969 F.2d 744 (9th Cir. 1992). The Ninth Circuit denied O'Melveny's Petition for Rehearing and Suggestion of Rehearing *en Banc.*

The Ninth Circuit acknowledges the motivation for its result by the emotional content of its paraphrase of O'Melveny's contention:

> that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within the corporate entity. 969 F.2d at 748.

Draped in its ethical mantle, the Ninth Circuit concludes, without the analysis required by controlling cases in this Court, that "while we *may* incorporate state law to provide the federal rule of decision, we are not bound to do so." 969 F.2d at 751 (emphasis added). The Ninth Circuit then fashioned a rule of federal law justified only by its acknowledged desire to maximize the "asset pool." 969 F.2d at 752.

WHY THE PETITION SHOULD BE GRANTED

This case presents many reasons why the Court should exercise its discretion in granting O'Melveny's Petition. O'Melveny's Petition has set forth several: First, the conflict between the Ninth Circuit's decision below and the Fifth Circuit's decisions in *F.D.I.C. v. Ernst & Young,* 967 F.2d 166 (5th Cir. 1992), and *F.D.I.C. v. Schrader & York,* 991 F.2d 216 (5th Cir. 1993) should be resolved. Second, given the hundreds of pending cases involving billions of dollars of claimed damages and hundreds of millions of dollars per year in defense costs to professionals, the Court should take this early opportunity to resolve the conflict, rather than waiting for further development in the Circuit Courts of Appeal. There is however, an equally pressing and fundamental reason why the Court should grant the Petition, and it is this reason *amicus curiae* desires to highlight.

This Court is the pinnacle of the American legal profession, and must be the guardian of its central values. The

Ninth Circuit's decision strikes at one of the most fundamental principles of our profession – that lawyers' relationships with their clients should be judged by known standards, established by the states that regulate their conduct, which are in effect when the conduct in question occurs. The Ninth Circuit believes that federal judges should invent, after the fact, the standards by which lawyers' conduct should be retroactively judged, with the only guiding principle being that the chosen standards must maximize the recoveries of FDIC and RTC in litigation against lawyers. This Court should exercise its position of leadership to give a prompt burial to that pernicious notion.

Private practitioners engaged in a local practice are directly regulated by the highest court of their respective states in matters of licensure, continuing legal education, and discipline. To the extent lawyers in their practice depart from the standard of care in their local communities, they should be subject to potential liability based upon that community standard of care. But a California law firm, which from its California office advises a California client on a matter, should not later face, as if through Alice's looking glass, a claim that as a matter of California law its client simply could not assert against it. The subsequent seizure of the client's business by federal regulators (who had themselves approved applications to insure the bank's accounts as well as the identity of the bank's directors and senior management, and made periodic examinations of its operations) cannot "create" a claim the client itself could not have asserted.

Bluntly stated, the Ninth Circuit's result is an absurd, unfair, and untenable position, properly deserving of Mr. Bumble's epithet.[1] This Court should take the opportunity to correct this appalling, unprincipled injustice to O'Melveny and to the entire American legal profession.

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[1] C. Dickens, *Oliver Twist*, Ch. 51 (" 'If the law supposes that,' said Mr. Bumble, . . . 'the law is a ass – a idiot.' ").

SUMMARY OF ARGUMENT

This Court has consistently held that federal courts should presumptively look to state law for rules of decision, unless specific federal program objectives *require* adoption of a uniform federal rule. Only when the elements articulated in *United States v. Kimbell Foods,* 440 U.S. 715 (1975) are met should a federal court fashion a rule of federal common law to displace a well developed body of otherwise generally applicable state law. The Ninth Circuit applied federal law to reach its desired outcome, without undertaking the *Kimbell Foods* analysis. Under that analysis, federal courts should clearly look to state law as providing the rule of decision in this case.

This Court has also rejected the notion that the federal government's desire to "maximize the asset pool" is a sufficient basis for inventing federal common law to displace a well developed body of otherwise generally applicable state law. *United States v. Yazell,* 382 U.S. 341 (1966); *United States v. Kimbell Foods, supra.* The Ninth Circuit intentionally disregarded these precedents in its result-oriented opinion. Moreover, a review of the policy history of federal regulation of thrifts – as written by the federal government itself – compels the conclusion that Congress and the regulators identified as early as 1983 the risks that faced the industry in light of its weakened capital position and newly granted powers to invest in real estate assets, and intentionally allocated the risk of a systemic failure, such as occurred in 1988–90, to the "taxpayers" in general rather than to professionals serving the industry.

ARGUMENT

I. *EVEN WHERE FEDERAL LAW APPLIES, THERE IS A PRESUMPTION THAT STATE LAW SHOULD BE INCORPORATED INTO THE FEDERAL COMMON LAW AS THE RULE OF DECISION.*

Even where substantive federal law must be applied, it does not necessarily follow "that the content of such a rule must be wholly the product of a federal court's own devising." *Kamen v. Kemper Financial Services,* 500 U.S. , , 111 S. Ct. 1711, 1717, (1991). The Court viewed its prior cases as establishing:

> that a court should endeavor to fill the interstices of federal remedial schemes with uniform federal rules only when the scheme in question evidences a distinct need for nationwide legal standards . . . or when express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand. *Id.*

Except in those narrow circumstances,

> We have indicated that federal courts should "incorporat[e] [state law] as the federal rule of decision," unless "application of [the particular] state law [in question] would frustrate specific objectives of the federal programs." *Id.*

These rules create a "presumption that state law should be incorporated into federal common law." *Id.* This presumption is "particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state law standards." *Id.*

The Ninth Circuit's opinion does not identify any statutory provision that "evidences a distinct need for nationwide legal standards." Nor does it point to "express

provisions in analogous statutory schemes [that] embody congressional policy choices readily applicable to the matter at hand." The Financial Institution Reform, Recovery and Enforcement Act of 1989, P.L. No. 101-73, 103 Stat. 183 ("FIRREA") and its legislative history demonstrate that Congress intentionally stopped short of imposing uniform federal standards for the elements of and defenses to professional liability of a thrift's outside professionals.[2]

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[2] In 1989, Congress specifically addressed the issue of what additional powers the federal banking agencies needed with respect to outside professionals who provided services to insured depository institutions. Although Congress authorized the banking agencies acting in their governmental (as opposed to receivership) capacity to assert a new cause of action against outside professionals, it imposed liability only for knowing or reckless behavior, not for mere negligence, and thus the FDIC could not have maintained this negligence cause of action had it brought suit in its governmental capacity. 12 U.S.C. § 1818(b)(6)(A); 12 U.S.C. § 1813(u). In making this determination, Congress was aware of the complex policy considerations involved and acted only after hearing the views of all parties (H.R. Rep. No. 54(I) at 466):

> [FIRREA] places limitations on the banking agencies, so that they cannot utilize their enforcement authority over independent contractors for necessarily the same misconduct, abuse, or violations which can give rise to enforcement orders against officers, directors, and employees of financial institutions . . . [I]nclusion of these independent contractors has raised the concern of the American Institute of Certified Public Accountants, the American Bar Association's Business Law Section, and other groups. The Committee believes that section 9001 addresses these concerns. Accordingly, the Committee has limited the exposure of independent contractors to serious misconduct.

This fundamental policy determination of Congress will be undermined if the Ninth Circuit's decision is allowed to stand. The Ninth Circuit, motivated solely to protecting the FDIC's "asset pool," would allow the FDIC to recover in this case even though (1) the FDIC could not recover under the cause of action specifically created by Congress to protect the deposit insurance system after extended hearings and careful consideration, and (2) the failed institution itself could not have recovered under established principles of corporate and professional malpractice law. Whatever one's view of the merits of the Ninth Circuit's analysis, the judiciary clearly is not the proper forum for these decisions to be

Nor does the Ninth Circuit's opinion identify any "*specific* objectives of the federal programs" that would be "frustrated" by application of traditional state law rules. Instead, it concludes that the generalized federal policy of "maximizing the asset pool" requires creation of federal rules whose only rationale is that they make it easier for the FDIC to establish liability and/or damages in cases it has chosen to file.

Nor does the Ninth Circuit analyze the impact of creating a federal common law rule on the parties' expectations that their rights and obligations would be governed by state law. ADSB was a state chartered thrift with its operations in California. Its legal relationships with borrowers, depositors, and vendors, including professional service providers, were thus based on an expectation that California law would govern. O'Melveny is primarily centered in California, and would expect that its relations with ADSB (like all its other relationships with California based clients) would be governed by California law. The attorney/client relationship has historically been governed by state law which establishes standards of ethical conduct, as well as the elements of and defenses to professional liability claims, and is intensely regulated by the states. The FDIC has shown no basis for disregarding the "ready made body of state law" and thereby frustrating the expectation of the parties.

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made. *See FDIC V. Braemoor Assoc.*, 686 F.2d 550, 554 (7th Cir. 1982) *cert. denied*, 461 U.S. 927 (1983) ("the absence of any ready-made federal common law in most of the areas of law in which it might be applied, and a general reluctance to displace state law without explicit statutory or constitutional direction to do so, support a presumption that state law is adequate and should be adopted by the federal court as the rule of decision.").

II. *THE FDIC'S INTEREST IN "MAXIMIZING THE ASSET POOL" IS INSUFFICIENT TO OVERCOME THE PRESUMPTION THAT STATE LAW SHOULD BE INCORPORATED AS THE FEDERAL RULE OF DECISION.*

A. *Prior Cases Reject Protectionist Fiscal Policies as an Adequate Justification for Refusing to Incorporate State Law as the Federal Rule of Decision.*

This Court has twice held that "protectionist fiscal policies underlying" a federal program do not constitute the showing of frustration of "specific objectives of the federal programs" required to override the "presumption that state law should be incorporated into federal common law."

In *United States v. Yazell*, 382 U.S. 341 (1966), the Government argued that maximizing recovery on SBA guaranteed loans required that federally insured SBA loan contracts prevail over state coverture rules. The Court properly observed that

> every creditor has the same interest in this respect; every creditor wants to collect. The United States, as sovereign, has certain preferences and priorities, but neither Congress nor this Court has ever asserted that they are absolute. 382 U.S. 348-49.

The Court rejected SBA's "generalized pleas for uniformity as substitutes for concrete evidence that adopting state law would adversely affect administration of the federal programs." *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 730 (1975).

Similarly, in *United States v. Kimbell Foods, Inc., supra*, SBA and FHA urged the Court to adopt federal common law lien priority rules to give the agencies priority over liens that were "inchoate" at the time the federally insured extension of credit occurred. Again, the interest advanced was that minimizing losses to the Government

required adoption of uniform federal rules. The Court rightfully described this interest as "protectionist fiscal policies underlying the programs." Such an interest is not the kind of "specific objectives of the federal programs" which must be frustrated by non-discriminatory state law in order to avoid the presumption of incorporating state law as the federal rule of decision. The Court held:

> We are unpersuaded that in the circumstances presented here, nationwide standards [favoring claims of the United States] are necessary to ease program administration or to safeguard the federal treasury from defaulting debtors. Because the state commercial codes 'furnish convenient solutions in no way inconsistent with adequate protection of the federal interest[s],' . . . we decline to override intricate state laws of general applicability on which private creditors based their daily commercial transactions.

The Court held that those "generalized pleas for uniformity" are not a substitute for "concrete evidence that adopting state law would adversely affect administration of the federal programs." *United States v. Kimbell Foods, Inc., supra,* 440 U.S. at 729–730.

The Court further examined the Government's assertion that "applying state law to these lending programs would undermine its ability to recover funds disbursed and therefore would conflict with program objectives." 440 U.S. at 733. The Government argued that it is impossible to distinguish between "a dollar received from the collection of taxes and a dollar returned to the treasury on repayment of a federal loan," so the fiscal interest which led to the "choateness doctrine" in the federal tax lien context justifies bringing those rules also into the federal lending programs. The Court described SBA and FHA programs as "a form of social welfare legislation, primarily designed to assist farmers and businesses that cannot obtain funds from private lenders on reasonable terms." 440 U.S. at 735. The Court then concluded:

> We believe that had Congress intended the private commercial sector, rather than taxpayers in general, to bear the risks of default entailed by these public welfare programs, it would have established a priority scheme displacing state law. Far from doing so, both Congress and the agencies have expressly recognized the priority of certain private liens over the agency's security interests, thereby indicating that the extraordinary safeguards supplied in the tax lien area are unnecessary to maintaining the lending programs. *Id.*

Finally, the Court noted that businessmen "depend on state commercial law to provide the stability essential for reliable evaluation of the risks involved," and that creating special rules for federal contractual liens "could undermine that stability." 440 U.S. at 739-40. Creditors who "justifiably rely on state law to obtain superior liens would have their expectations thwarted whenever a federal contractual security interest suddenly appeared and took precedence." *Id.* Since the Government was unable to advance any "concrete reasons [as opposed to 'protectionist fiscal policies' underlying the program] for rejecting well established commercial rules which have proven workable over time," the Court took the "prudent course" of adopting "the ready made body of state law as the federal rule of decision until Congress strikes a different accommodation." 440 U.S. at 740.

In this case, as in *Kimbell Foods, Inc.* and *Yazell,* the Ninth Circuit's justification for a uniform federal rule favoring the FDIC is only the generalized interest in maximizing the asset pool. As in *Yazell* and *Kimbell Foods, Inc.,* these generalized assertions are not a substitute for a showing of "specific program objectives" that would be frustrated by

applying non-discriminatory state law establishing the elements of and defenses to a professional liability claim. Congress had the opportunity "to strike a different accommodation" when it enacted FIRREA, but made a clear choice not to do so.[3]

[3] *See* Note 2, *supra*. The Ninth Circuit also seems to justify its federal common law rule with the observation that "a receiver . . . does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects." 969 F.2d at 751-52. The Ninth Circuit ignores completely the fact that the FSLIC was not obligated to insure the deposit accounts of all state chartered savings and loan associations. 12 U.S.C. § 1726(a)(2). It insured only those who applied for insurance and met the requirements imposed by FSLIC. 12 U.S.C. § 1726(b). One of the key requirements for insurance of accounts is a regulatory finding of satisfactory management. The statute provides that FSLIC "*shall* reject the application of any applicant if it finds that the applicant is impaired or that its financial policies or management are unsafe; and may reject the application of any applicant if it finds that the character of the management or its home financing policy is . . . inconsistent with the purpose of this chapter." *Id*. Under the applicable statutes, the FHLBB had the power to examine the institution periodically, to issue cease and desist orders, and to take other appropriate regulatory action including supervisory agreements requiring advance regulatory approval of significant transactions, and withdrawal of insurance of accounts, if an institution was not being operated in a safe and sound manner, or if its regulatory capital was impaired or threatened, or if it were violating any applicable law, rule or regulation. 12 U.S.C. § 1730(b). It also had the power to suspend or remove directors or officers who violate statutes, rules or regulations or engage in unsafe and unsound practices. 12 U.S.C. 1730(g). FHLBB had the power to examine the affairs of an insured institution and take supervisory action based thereon. 12 U.S.C. §§ 1726(b), 1730(m)(1)–(3). "FHLB examiners were investigating ADSB for two years prior to the takeover. The regulators were closely overseeing the thrift and had the ability, either independently or through FSLIC, to uncover the facts and notify ADSB of the discovery." *California Union Ins. v. American Diversified Savings Bank*, 948 F.2d 556, 565 (9th Cir. 1991). Thus, federal regulatory authorities had a great deal of information concerning and control over ADSB before becoming its receiver.

B. *Congress Increased the Risks to the FSLIC Fund, Failed to Enact Recommended Reforms, and Expressly Allocated the Risk of Systemic Failures to Society as a Whole.*

The FDIC's "asset pool argument" expressly invokes the Court's sympathy for the plight of the "taxpayers" who bear the cost of the "bailout" granted by Congress to the depositors of failed thrifts. To the extent such policy judgments are the province of the judiciary at all, a brief review of the policy history demonstrates that such pleas for sympathy are unfounded. Congress enacted laws which dramatically increased the risk to the FSLIC fund and then failed to enact reforms to address the resulting "instability," which the Federal Home Loan Bank Board ("FHLBB") identified in writing to Congress. Moreover, the FSLIC fund was never meant to be large enough to handle systemic failures; federal policy was to spread the cost of systemic failures "across society" using "general revenues of the Government."

Since 1987, one-third of savings and loans nationwide have failed, concentrated in Texas, Louisiana, Florida, and the Southwest. These failures accompanied regional real estate depressions and consequent precipitous declines in the value of real estate owned by, or securing loans held by, thrifts. That such large numbers of the nation's thrifts have failed since 1988, clearly indicates systemic or macroeconomic failures.

As early as 1983, the FHLBB, in a congressionally mandated report to Congress, warned that the decimation of the thrift industry by the high interest rates and negative yield curve of the early 1980's, coupled with partial deregulation of the industry accomplished by congressional and regulatory action between 1979 and 1982, created a clear danger of industry-wide, systemic failures.[4] In the introductory section, the FHLBB states the problem and sounds the ominous warning:

[4] FHLBB, *Agenda For Reform, A Report to the Congress From the*

> Federal deposit insurance was created during the Great Depression as a way of restoring public confidence in the U.S. Financial system. Indeed, the legislation of that time developed and installed a new financial structure for the nation. As stability gradually returned, banks and thrift institutions regained their health and grew at a measured pace under close government regulation.
>
> More recently, however, conditions in financial markets have become increasingly volatile. Additional pressures on regulated depository institutions have resulted from the innovations of unregulated firms and investors. Deregulation has occurred in many sectors of the economy, with substantial changes taking place in the financial services industry.
>
> Partial deregulation, however, has created its own problems. Deposit insurance was designed for one regulatory structure, but a very different one is now developing. **The current system is unstable; without reform, it threatens the viability of federal deposit insurance.** *Agenda for Reform* at 10 (emphasis added).

The report noted that recent legislative changes had "lowered the barriers that have segmented commercial banks from S&Ls" and "relaxed the constraints that were imposed on managers of S&Ls regarding the composition of both the asset and liability sides of their balance sheets." As a result, "there is now a much greater opportunity for

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Federal Home Loan Bank Board (U.S. Government Printing Office, Washington, D.C. 1983) (hereinafter "*Agenda for Reform*"). The FHLBB notes that *Agenda for Reform* was prepared "with the invaluable help of a Drafting Committee of distinguished scholars, commentators who represented a broad range of professional experts, and the Bank Board Staff." *Agenda for Reform* at iii-v, 2, and Appendix D.

managerial capabilities to be reflected in performance." FHLBB observed that "these changes do not guarantee the savings and loan industry a bright future," but only permit and require the industry to compete with other financial service companies; and warned that "those that are not prepared to compete in the next decade will not survive." *Id.* at 39.

The FHLBB noted that this competition presents FSLIC with "a new set of problems," requiring that FSLIC

> protect itself as well as the depositors in insured institutions by seeking to control risk taking by managers of insured institutions without the kind of direct regulatory constraints that have been available in the past. *Id.* at 40.

The FHLBB explained that "financial institutions were originally regulated" to control "the risk associated with depository institutions' actions." In the future,

> insurance agencies must limit risk through regulations that constrain the activities of insured institutions or through pricing mechanisms that provide proper incentives for risk-taking. **If neither option is available, then the insurance agency is exposed to considerable risk.**
>
> Although the deregulation of the past few years was a necessary response to marketplace innovations, **it has also substantially limited the ability of regulatory agencies to constrain the risk-taking of insured institutions.** Moreover, this has occurred at a time when there are a number of insured institutions that are operating with impaired capital and have strong incentives to engage in very risky investments. **In light of**

the competitive pressures that the industry will face in the next few years, this deregulation could result in substantial losses. *Id.* at 40-41 (emphasis added).

The report specifically addressed the potential risk to the deposit insurance system of the broadened powers of S&Ls to engage in real estate activities, making the following points:

1. In the real estate business "either bad management or bad luck, or both, . . . can result in substantial losses." *Id.* at 73.

2. The timing of thrifts' entry into the real estate business was not good, because occurring "at the same time that they are facing the need to compete without the protection of deposit interest rate ceilings" and because "the current U.S. economic outlook is rather unfavorable." *Id.*

3. Inflation, which "has played an important role in bailing lenders out of mistakes in real estate lending" is gone; but if real estate prices "do not rise each year, S&Ls may face an increase in credit losses." *Id.*

4. S&Ls are being encouraged to enter these new market areas at a time when "Operating losses in the past couple of years have eroded the net worth positions of S&Ls, reducing their capital cushion." As a result, "Many institutions are simply too weak to restructure their operations toward new business endeavors without assuming undue risks. Some S&Ls may take these excessive risks because they believe that their weakened financial condition leaves them no choice – that is, they believe that they must restructure to survive." *Id.*

5. Federal deposit insurance allows S&Ls to "stay in business even after their capital is depleted because their creditors (depositors) have confidence in the deposit insurance system. Moreover, not only can these institutions stay in business, they can also obtain the funds they need to undertake risky ventures . . . Now because of their weakened condition, some S&Ls have every incentive to take excessive risks, and this may lead to increased problems in the future. *Id.*

On the adequacy of the FSLIC fund, the FHLBB reported:

> The recent problems of the savings and loan industry, and so of the FSLIC, . . . could have been handled with minimal losses to the insurance fund had the FSLIC closed S&Ls when their real net worth approached zero. However, such a policy would have resulted in the closing of nearly every S&L in the country . . .
>
> The current size of the fund is, of course, inadequate to deal with a drastic deflation and depression of the kind that occurred in the 1930s. **It is inefficient and impractical to require that the fund be large enough to cover the losses associated with such a calamity. Such catastrophes are more appropriately a general obligation of the government than of an insurance fund drawn from user fees.** *Id.* at 18 (emphasis added).
>
> [T]he industry should not be expected to provide a fund adequate for protection against a general collapse of the economy; **it is more appropriate to use the general revenues of the Government to spread the cost of such a collapse across society.** *Id.* at 82 (emphasis added).

The FHLBB acknowledged that its success in dealing with the crisis of the early 1980s by "avoiding both financial

disaster and a loss of public confidence in deposit insurance" is not "wholly reassuring" because "conditions under which the FSLIC fund would not be adequate can readily be imagined." *Id.* at 79.

The FHLBB made nine specific recommendations for assuring the future adequacy of the FSLIC fund. *Id.* at 80–82. Those proposals included re-regulation, which was acknowledged as running "counter to the trend toward less regulation of financial institutions." Other options included reduction in the level of FSLIC coverage, requiring enhanced capital for existing S&Ls (including higher capital requirements for institutions taking greater risk), requiring institutions to pay risk sensitive rather than uniform premiums for deposit insurance, and increasing insurance premiums.

Congress chose not to address the "unstable federal deposit insurance system" by enacting any of the FHLBB's 1983 reform proposals. This industry's capital buffer was not increased. The FSLIC fund was not bolstered by increased uniform premium rates, or by risk based premiums for the institutions that took greater risk. Risk taking was not discouraged through the "pricing mechanisms" of either higher capital requirements, or increased insurance premiums, for institutions that chose to take greater risk for greater potential reward. Nor was risk-taking discouraged by re-regulation.

Congress did, however, enact the Tax Reform Act of 1986, P.L. No. 99-514, 100 Stat. 2085, which eliminated the strong tax incentives[5] that had fueled the real estate boom which had enabled savings and loans to expand their real estate activities under the expanded powers acquired with deregulation. What followed, predictably, was economic

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[5] These real estate tax incentives were significantly enhanced by the Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 172, which coincided with deregulation of the thrift industry.

depression in regions of the country where real estate development was a substantial part of the local economy. As the FHLBB had predicted, with the collapse of real estate values "credit losses" increased dramatically. More than 700 thrifts, generally those that after deregulation had taken on significant real estate exposure, failed. As the FHLBB acknowledged in 1983, the insurance fund was never designed to cover such systemic problems; rather the "general revenues of the government" would be used "to spread the cost of such a collapse across society."

Congress and the President delayed through three election years (two presidential elections) before implementing any of the 1983 reform proposals. They finally responded by enacting FIRREA in 1989. Four years later, the FIRREA Commission – appointed to determine the causes of the thrift debacle – reported on its extensive study of the problem. It concluded that the regulatory policy of allowing thrifts to expand rapidly into riskier businesses on significantly eroded capital bases made the "S&L debacle all but inevitable."[6]

Like the loan guaranty programs in *Yazell* and *Kimbell Foods,* the federal deposit insurance system is "a form of social welfare legislation." *United States v. Kimbell Foods,* 440 U.S. at 735.[7] As the Court held in *Kimbell Foods,* "had Congress intended the private commercial sector [i.e. professionals representing thrift institutions] rather than taxpayers in general, to bear the risks entailed by these

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[6] National Commission on Financial Institution Reform, Recovery and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform,* A Report to the President and Congress of the United States (U.S. Government Printing Office, Washington, D.C. 1993) 33; 41-43, 43-61.

[7] That social welfare legislation was designed to promote a firmly entrenched national housing policy, and to create a more efficient method of assuring public confidence in the system of savings institutions than market-based methods that would exist in the absence of regulation and deposit insurance. *Agenda for Reform* at 13-16, 40-41.

public welfare programs, it would have" provided that professionals are absolutely liable to FDIC without the necessity that it prove traditional elements of professional liability and without the ability to assert defenses. This it did not do.

If outside professionals failed to meet prevailing state law standards at the time the conduct occurred, they should be held liable. But in light of the policy history, no congressional intent can be discerned or justified to shift to outside professionals who provided services to thrift institutions the societal costs which resulted from increased risks to the FSLIC fund legislated by the taxpayers' elected representatives, from their failure to enact FHLBB recommended reforms, and from systemic failures which under established federal policy were to be "spread . . . across society" using the "general revenues of the Government."

CONCLUSION

The Ninth Circuit's decision defiles a central principle on which the legal profession has operated. It rushes to invent "federal law" to arrive at a result obviously dictated by its own social biases, without demonstrating the necessity of departing from well established, nondiscriminatory state law. This perpetrates a grave injustice on O'Melveny and on the entire American legal profession.

The Petition should be granted, and the Ninth Circuit's decision should be reversed and the case remanded for entry of judgment in favor of O'Melveny.

Respectfully submitted,

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